INVESTMENT PENSIONS & OVERSIGHT COMMITTEE

WEDNESDAY, JULY 27, 2011

Securing financial futures
NMERB
since 1957

NEW MEXICO
EDUCATIONAL
RETIREMENT
BOARD

The $1,500,000 "mistake"??

- Recently, a KOAT TV reported on a 2010 ERB decision the to terminate an investment manager in 2010. It was reported that the decision resulted in the needless expenditure of over $700,000 in fees.
- The report did not include the total impact of the decision as certain facts were not included.
- The report was incorrect in the magnitude of the decision. The actual dollar of the total impact was actually almost **$1,500,000.**
- The report was also incorrect in the sign of the impact. The $1,500,000 was a ***GAIN for the state <u>NOT</u> a loss*** when all relevant factors were included**.**

Sequence of Events

- In 2002, ERB hired Rothschild to manage a small cap. value equity portfolio.
- Over the years, the performance was generally good, so the contract was extended.
- During 2009, ERB renegotiated the fee structure for Rothschild from a flat fee of 67 basis points of assets under management (0.67%) to a base fee of 20 basis points, plus a performance incentive if a certain performance hurdle was met. This was agreed to on 10/1/09, but contained a clause that said the fee would revert to the original 67 basis points if Rothschild were not under contract for a full 12 months.
- Also during 2009 the performance turned negative compared to their benchmark index. All managers are measured against broad market indexes to evaluate their performance.

Events (continued)

- In December 2009, the manger was asked to appear before ERB Investment Committee due to deteriorating performance. Performance did not subsequently improve and the decision was made to issue an RFP to replace the manager.
- For the twelve months ending March 31, 2010, the Rothschild portfolio underperformed their index by a full 25.9%. This represented an opportunity cost of approximately $39,000,000 in lost profits to the ERB.
- With this information in hand at the June 4, 2010 Board meeting, the decision was made to hire Lord Abbett and to terminate the Rothschild contract. Staff overlooked the timing element of the new fee clause and did not bring it to the Board's attention during the discussion.
- ERB terminated Rothschild in late July and transitioned $100,000,000 in assets to Lord Abbett on August 1, 2010.

Total Impact

- The early termination of the contract resulted in a fee that exceeded the budgeted amount by $619,000. This was due to the fact that budget projections were improperly calculated under the new fee agreement.
- The substitution of Lord Abbet for Rothschild in the relevant period (8/1/10-9/30/10) also resulted in an incremental increase in investment earning of $2,077,000. In other words, had ERB retained Rothschild it would have earned $2,077,000 less in investment income.
- Thus, the **net total** impact to the ERB fund was a gain of $1,458,000:

Investment Gain:	$2,077,000
Minus incremental fee:	-$619,000
Net Gain:	$1,458,000

Calculation of Net Gain

	Rothschild	Lord Abbett
Original investment 8/1/2010	$ 100,000,000	$ 100,000,000
August 2010 performance	-7.94%	-5.00%
Ending August account balance	$ 92,060,000	$ 95,000,000
September performance	11.70%	10.43%
Ending September balance	$ 102,831,020	$ 104,908,500
Lord Abbett advantage		**$ 2,077,480**

Note: The Lord Abbett performance is calculated based upon actual performance as detailed in ERB Monthly reports Rothschild performance is as reported to eVestment and represents a composite of accounts in the Small cap value strategy that ERB had invested in.

Summary

- In the end, ERB staff did make an error. The main impact of this error was the underestimation of the manager fee for budgetary purposes. This was corrected through the mechanism of a budget adjustment request (BAR) to appropriate the additional monies. This BAR was discussed with the Board at the September 15, 2010 Board meeting.
- Nonetheless, even if one wishes to categorize the $619,000 difference as an extra expense the total monetary impact to the ERB fund was still a **positive** $1,458,000 when the incremental investment income that the decision produced is also taken into consideration.

Securing financial futures
NMERB
since 1957
NEW MEXICO EDUCATIONAL RETIREMENT BOARD